

BOOST YOUR INCOME

INVESTING FOR INCOME

The current low interest rate climate has thrown some of even the most diligent savers off course. The traditionally fail-safe source of income – interest from a higher rate savings account – has been suffering from the combination of low interest rates and rising inflation. But many investors are reluctant to take on higher risk, so what are the options for the investor that needs an income in such an environment?

THE ALTERNATIVES

1. CORPORATE BONDS

Corporate bonds are loans taken out by a government or company. Rather than banks, it is investors who lend them the money and in return receive interest payments during the term of the loan, plus return of their capital at the end of a set period.

a. Government bonds


As the name suggests, Government bonds are issued by Governments and are used to finance the running of an economy or infrastructure development. The interest rate offered when the bond is issued will take into account that country's current central bank base rate and future expectations

for that base rate. It will also take into account the perceived likelihood of default for that country. So, for example, an emerging economy would have to offer a higher interest payment than a developed country simply because the market would perceive it more likely to default on that debt.

UK Government bonds (otherwise known as 'Gilts') are normally issued for extended periods of time and are used extensively by institutions such as insurance companies to underpin some of their long term liabilities. For individual investors, they can be a low risk way to access long term predictable levels of income. Unlike some other countries in the world, the UK has never (to date) defaulted on its debts, not even during the crisis of the 1970s.

b. Corporate bonds

More broadly, corporate bonds are the same as government bonds, except investors are lending to a company rather than a government. In general, this is thought to carry more risk, though in practice the risk involved in lending to a large multi-national blue-chip can be very similar to lending to a large developed country – and the risk in lending to a small, newly established company will differ only slightly from that of lending to some of the smaller or less predictable emerging economies.



However, whilst base rates dictate the environment for corporate bonds, the perceived risk involved is also a big factor in how much income you will be offered for your loan by any individual company. It is therefore very important to understand that risk by doing some research before making a decision. Many of the big fund managers do this research in-house but they, along with those of us without access to such resources, are helped by agencies such as Moodys & Standard & Poors who assign 'credit ratings' to companies who offer the bonds.

Without going into too much detail, the effect of these credit ratings is to divide corporate bonds into two classes – 'investment grade' for the highest credit ratings and sub investment grade (also called high yield and sometimes 'junk') for the lowest. The lower the credit rating, the higher the amount of income you will receive – as a way of compensating for the extra risk you are taking.

However, be aware that, although investment grade corporate bonds are regarded as a lower risk asset class and suitable for general consideration, the higher yielding sub-investment grade bonds are not. According to figures from the US¹, the chances of losing money on an average sub investment grade bond can exceed 40% - and for the very lowest rated (grade CCC and below) could be as much as almost 70%. Hence the nickname 'junk'.

1: US Date compiled as part of the Municipal Bond Fairness Act 2008, based on Standard & Poors' ratings

c. Collective funds

Collective funds investing in corporate bonds will contain a managed portfolio which can help you to diversify some of the risk by targeting many different investments rather than just one or two. Some will even focus on a single area of the market for you – perhaps investment grade or maybe just the very highest rated. However, 'strategic' bond funds have also become more popular recently, particularly from the asset managers with larger in-house research teams. Strategic bond funds are 'go anywhere' funds where the manager will take a view on the area of the bond market which they think offers most value. They could therefore offer an introduction to the sub investment

Advantages of bonds

- **Stable, predictable income stream and return of capital at the end of the term**
- **Volatility of capital values tends to be lower than equity markets**
- **Even in default, bond investors are usually 'preferred' creditors and may therefore still get some money back**

Disadvantages of bonds

- **Fixed income levels mean the value of that income can be eroded in an inflationary environment**
- **Some parts of the bond market can be illiquid, particularly lower ratings and some overseas options**
- **Beware sub investment grade bonds unless you are prepared – these are not generally suitable for the low-risk investor**

grade area or overseas opportunities if as an investor, you don't mind taking on some of the higher associated risks.

2. EQUITIES

As the name suggests, equity investors buy a stake in a company and, in return, participate in any financial rewards generated by success. For income investors, the most important reward is the dividend payment, ie: the amount of annual profit that company pays out to its shareholders.

However, you will not just receive dividends from any old company listed on the stock market. For example, a company still in the early stages of life will have very unpredictable profits as it seeks to establish itself – and any profit it does make will probably be used either to repay start up costs or as a reinvestment to help growth. Even as a company gets older, there may be reasons for it wanting to keep any profits for debt financing, expansion or product development needs.

Consequently, when you find a company that IS paying consistent levels of dividend, it will tend to be one which is larger and more established in its industry – 'blue-chips' in the jargon of the markets.



This does not mean that dividend investing is without risk. Firstly, there are the exceptions which prove the rule and not all dividends come from established, blue-chip companies. Second, even large companies hit hard times so dividends may need to be cut or even stopped. At the same time, your capital is also at risk as the price of any company's shares can go down as well as up affecting the value of your original investment.

Using a collective fund can help manage this risk by giving access to a broad spread of companies. This can help compensate for problems in one company by benefiting from upsides in others.

Overseas opportunities

Until relatively recently, the majority of equity income investors focused on the UK, where there are plenty of large multi-national companies paying consistently high dividends. The FTSE 100 Index is dominated by pharmaceuticals, energy companies, banks and telecoms, all of which tend to be large dividend

Advantages of equities

- **Highly liquid and transparent**
- **Dividend income offers the potential for some inflation-protection.**
- **Dividends act as a valuation discipline (ie: if the share price rises too far, the yield drops making the stock less attractive)**

Disadvantages of equities

- **Equities are volatile. Share prices can go down as well as up and you may not get back the amount you invested**
- **Company dividends are not guaranteed. Company profits and therefore your income can also go down as well as up.**

payers. An established dividend culture did not exist in other countries particularly areas such as Asia.

However, that situation has changed substantially over the past decade. The US hosts a core of high-dividend paying, mostly multi-national companies and, more recently, Asian companies have sought to attract and meet the needs of international investors by also focussing on higher dividends. Countries such as Hong Kong and Taiwan now have established dividend regimes.

A global income approach is therefore now far more realistic and a number of fund management groups have launched funds to tap into this trend. For investors already exposed to the UK equity income market therefore, this might offer the chance to access new sectors and gain wider diversification.

3. PROPERTY

Property has its fair share of critics. Many consider it an illiquid asset class, and believe that investors already have an over-allocation within their investment portfolios, either simply because they own their own home, own a buy to let – or for some, because they are invested in commercial property through their business. However, for those who are not over-exposed, or who are attracted to its benefits on a wider basis, it has a part to play in an income portfolio.

Property is basically divided into two parts – residential property and commercial property. Buy to let is the main way in which investors in residential property seek to generate income, through rents negotiated on short-term tenancy agreements. The main objective for such investors more recently, however, has been to use rental income to support mortgage payments and make the bigger profit in the form of capital gain when the property is sold.

The provision of a high, consistent dividend income has,

however, always been the main function of commercial property investment. Income is generated through rents, the same as residential property, but the lease agreements negotiated with commercial tenants are much longer term (10-15 years as opposed to 6-12 months) and can come from a range of different sectors. From City real estate to warehouses to shopping centres to industrial parks, each sector commands a different level of rental yield and a different level of sensitivity to the economic environment.

Smaller investors can access commercial property through collective funds. These help to diversify the risk of losing a tenant from one property by spreading the investment across many different properties – or across the shares of many different property companies.

OTHER CONSIDERATIONS

Advantages of commercial property

- Rents might be contractually protected against inflation
- They tend to be more stable than equity dividends
- Long-term diversification from equity and bond markets

Disadvantages of commercial property

- Can be illiquid compared to bonds and equities and selling property investments can be a long process. It may be difficult to get your capital investment back quickly
- The value of properties and the rental income from them can go down as well as up
- Direct investment in individual commercial properties can involve a significant investment

Before deciding on the right blend of assets to generate an income, you should also make sure you consider the following issues as they might impact the decisions you make:

Inflation

Inflation is a measure of how the price of goods changes over time. If, for example, the cost of running your house increases by 5% in a year, you need to earn 5% more to pay for the same level of comfort.

There are therefore two issues:

- If you are looking to maximise the income from your investments to pay for everyday expenses, you need consider how much impact inflation will have and, particularly over longer periods, whether some form of specific inflation protection is required.
- If you decide to invest in a fixed rate investment – a corporate bond, gilt or deposit account – be aware that inflation will definitely have an impact. For example, a fixed rate of 4% is valuable when inflation is, say, 2%. However, if inflation is 5%, a 4% return looks less attractive.

Diversification

Spreading your eggs around a number of different baskets is as important in building an income portfolio as it is in building any other investment portfolio. Every source of income is likely to carry some risk. However, if you have all your income coming from one corporate bond, one company, or even just one asset class, you are vulnerable to erosion of your income long-term.

SUMMARY

Investors have plenty of choice when it comes to income and it is therefore worth at least discussing the opportunities offered by every one. Whether you are a cautious investor or one willing to take on the highest risks, give us a call and we can help you find the most suitable solution to meet your needs.

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